

GUIDEPOSTS FOR A FIRST PUBLIC OFFERING

Panel Discussion

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before

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Any discussion of accounting problems that may arise in connection with the review of financial statements of companies filing for the first time with the SEC should be considered in the light of the following statistics, which I think highlight the tremendous impact in the capital markets of new public financing.^{1/}

In the decade that has elapsed from fiscal 1950 through fiscal 1960 the Securities and Exchange Commission has experienced a constantly accelerating number of filings under the Securities Act of 1933 for the purpose of offering securities to the public. For the fiscal year ended June 30, 1950, 496 registration statements were filed. During the fiscal years 1958, 1959 and 1960 there were, respectively, 913, 1226 and 1628 registrations. In the first 9 months of this fiscal year, 1237 registration statements were filed, being 2 less than last year. In addition to the above, there is another statistic that is highly significant. In 1958, the number of issues of companies which had not previously filed registration statements was 28% of the total. In 1959, the ratio reached 39% and in 1960 the ratio was 48%, and it is this trend, I believe, that is particularly important to this audience.

In view of the above, and with particular reference to the smaller practitioner who may not have had any previous experience with the SEC, it seems incumbent that knowledge of the workings of the Commission should be part of the public accountants' responsibilities. My own experience has indicated that, in some cases where local accountants with no previous SEC

^{1/} The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

experience have certified financial statements in a registration statement, unnecessary time, effort and expense have been incurred in correcting the original filing by amendment because the local accountant had not developed the necessary professional skill in this type of work to prepare the financial data required.

For the particular benefit of these accountants in the audience who may at some time be involved in a public offering I would like to discuss the following points, knowledge of which are a necessity prior to actually engaging in an examination for purposes of a registration statement:

- 1) Independence of Accountants.
- 2) Familiarity with the Rules and Regulations of the Commission.
- 3) Special Format of Presentation.
- 4) Application of Generally Accepted Accounting Principles.

The subject of independence of accountants has been repeatedly discussed in talks by Mr. Andrew Barr, Chief Accountant of the Commission, whose office passes upon questions of independence. However, in view of the number of inquiries that are constantly being received by that office and the possibility that some accountants are not aware of the specific tests of independence prescribed in Rule 2-01 of Regulation S-X relating to qualifications of accountants, I will quote the rule:

Rule 2-01. Qualifications of Accountants.

"(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public

accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

"(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Rules 2-01(a) and 2-01(b) are self-explanatory. However, there are always exceptions to any rigid rule and Accounting Series Release No. 81 listed some cases of possible conflict of interest which upon examination proved to be situations in which the certifying accountant could be deemed to be independent, conditioned in certain cases upon remedial action being taken.

With respect to Rule 2-01(c), I would think that the most troublesome problem results from bookkeeping services commonly referred to as "write-up" engagements which are so frequent in smaller companies, particularly because of lack of competent accounting personnel. Although exceptions have been made for emergency services, our experience has shown that the application of the rule is necessary in this situation and consistent with the accepted concept that financial statements are the responsibility of management.

Over the years the Commission has promulgated a number of forms for registration under the Securities Act of 1933, the most important being Form S-1, which form is used when no other form is authorized or prescribed. These forms contain instructions as to the financial statements required to be filed, whether parent company, consolidated, group or combination of statements, companies acquired through pooling of interests during the period covered and companies acquired by purchase after the balance sheet date, and the required dates and periods.

In addition to the instructions as to financial statements, Item 6 of Form S-1 covers the instructions as to the "Summary of Earnings", the preparation of which is of particular interest to the certifying accountants since it usually is also covered by the certificate, and, in my opinion, probably represents the most significant item in the form in so far as the company, public investors and underwriters are concerned. I think it safe to say that Item 6 has been cited for corrections, revision, expansion, emphasis or de-emphasis more than any other item in Form S-1. Generally this is because of improper accounting presentation or because the last sentence

of the introductory paragraph of Item 6, reading, "In connection with such summary, whenever necessary, reflect information or explanation of material significance to investors in appraising the results shown, or refer to such information or explanation set forth elsewhere in the prospectus", has not been observed.

Among the common deficiencies cited in connection with the summary of earnings are (1) incorrect computation of per-share earnings, (2) failure to adjust retroactively for stock-splits or stock dividends, (3) omission of necessary information as to abnormal gross-profit percentage relationships from year to year, (4) omission of information as to the per-share effect of carry-forward benefits in the profitable last year or years of the summary, (5) omission of information as to the amount and expiration of such carry-forward benefits, and (6) omission as to significance of seasonal nature of the registrant's operations particularly in connection with the last interim period. This last factor is particularly important in those filings where special audits are made prior to the fiscal year end and the prior historical record shows the balance of the year to be a loss period. In addition to the above, a number of companies filing for the first time have had recapitalizations in which the stock sold to the public will have prior dividend preferences whereas the stock retained by management will either have nominal subordinate dividend rights or no dividend rights, in both cases with conversion rights over a period of years generally based upon fixed percentages. In such cases, earnings per share are required to be computed upon the total number of both classes of stock outstanding. However, when appropriate, no objection has been raised to showing separately the earnings coverage of the public class

of stock as related to the dividend priority of such stock provided adequate disclosure is made as to the potential dilution of such coverage as a result of the convertible feature of such stock.

In addition to the different forms, the Commission's rules regarding certification, form and content of financial statements and supporting schedules required to be filed for most purposes under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, as well as minimum disclosure required in supplemental footnotes, are prescribed in Regulation S-X. In this connection, I have noticed that the method of financial presentation varies to some extent among the larger practitioners and varies considerably among the smaller practitioners, possibly because they have not been aware of the concept that financial presentation for public view must of necessity be somewhat different than the detailed information that is necessary when made part of a "long form" report to management. As a matter of fact, writing of footnotes is somewhat of an art. Clarity and conciseness of expression, reasonable condensation of financial presentation, particularly with respect to minor items, tabular presentation of financial data wherever appropriate in lieu of narrative discussions, should be the desired goal. Finally, as discussed before, since financial statements are the responsibility of management, footnote disclosure should be couched in terms of management rather than in terms of the certifying accountants. This means that if comment as to auditing procedures is necessary it should appear in the certifying accountant's opinion rather than in the company's notes.

Although the various forms cover in general terms the type of financial statements required to be included in a registration statement, it is obviously impossible to write rules covering every type of situation that we run into in reviewing the financial statements. As a result, Item 13 of the Instructions as to Financial Statements of Form S-1 provides for the filing of other statements in addition to, or in substitution for, the statements required by the form where it is deemed necessary or appropriate for an adequate presentation of the financial statements. Quite frequently a family group of companies will be put together prior to a public offering. This may require recasting of all financial statements to a common fiscal closing date, with elimination of intercompany profits for the periods covered, resulting in what is in effect a pro-forma consolidated operating statement consistent with what the financial structure of the company will be after the public offering.

In addition to the above, the use of pro-forma statements in addition to or in substitution for historical statements has become increasingly necessary in recent years because of transactions entered into prior or subsequent to the balance sheet date by companies offering securities to the public for the first time. For example, corporations which have succeeded to partnerships would require recasting of partnership operating results to a pro-forma corporate basis, corporations which have availed themselves of the provisions of Sub-Chapter S of the Internal Revenue Code would require recasting of operating results to provide for the pro-forma corporate taxes and a family group of corporations which intended to merge into a single corporate entity would be required to eliminate the tax benefit resulting

from a multiple corporation set-up. Similarly, a company acquired by a promotional group with a substantial step-up in fixed asset values and new debt structure would be required to show in addition to the historical operating results (generally with no per-share data) a pro-forma statement of income for the latest 12-month period or the latest fiscal period and interim period giving effect to new depreciation charges, interest charges and related tax reduction in order that per share data correctly reflect the operating results of the company in terms of conditions existing at the time of the public offering. In addition to the above, quite frequently a registrant will acquire by purchase a material subsidiary or division close to the balance sheet date or after such date. If it appears that the historical operating results of the registrant could be materially affected by such acquisition, pro-forma operating statements would be required showing the operating results as if the acquisition had been made as of the beginning of the latest 12-month period.

The foregoing examples are to be contrasted with situations where the underwriter wishes to present an additional statement of financial condition giving effect to the results of the public offering, particularly when the historical balance sheet shows an unbalanced working capital position or excessive debt which will be materially changed as a result of the public offering and it is felt that the prospectus prose dealing with the application of proceeds is not as easily understood as statement presentation. The use of such a statement is limited to the underwriting conditions discussed in Rule 170 of the General Rules and Regulations under the Securities Act of 1933, the gist of such rules limiting its use to either a firm underwriting

commitment or an "all-or-none" arrangement with full refund of subscriptions to stock if the underwriting is unsuccessful.

It may be a little puzzling to some of you to realize that questions as to the application of generally accepted accounting principles have been repeatedly raised by the staff even though the financial statements have been certified without qualification. Primarily, this results from either lack of knowledge of accounting bulletins promulgated by the American Institute of Certified Public Accountants and accounting releases by the SEC, or reliance upon income tax rulings as being acceptable for purposes of financial reporting. Following tax accounting, statements have been certified in which all overhead has been omitted from inventory even though material in amount, cash basis rather than accrual accounting has been followed when inventories are not a material factor, provision for anticipated losses has not been reflected in the financial statements, deferred charges have been amortized over a time basis rather than a more realistic unit of production basis, "good-will" has not been amortized over a period although clearly related to an asset having limited life and acquisitions by purchase have been accounted for in a tax-free exchange in accordance with tax rulings rather than the accounting discussed in Chapter 5 of Accounting Research Bulletin No. 43. On the other hand, there are a great many filings which reflect differences between tax accounting and accounting for financial purposes which obviously are not evidence of incorrect accounting but are based upon an attempt by the registrant to (1) more clearly match costs and revenues, or (2) to present statements which follow an acceptable alternate method of accounting. In the first category we find companies that have deferred

research and development costs, publishing companies that have attempted to match subscription expense as related to subscription income, home building companies that have deferred selling, general and administrative expenses, real estate companies that have capitalized interest and taxes during construction, finance corporations that have deferred the first year of operating deficits of newly organized offices, certain types of companies with multiple retail locations that have deferred specific types of pre-operating costs and newly organized companies that have deferred starting-up costs and which in all instances follow a different basis for tax accounting.

In the second category we find companies that have followed liberalized depreciation for tax purposes versus straight line for book purposes, and completed contract for tax purposes versus percentage of completion for book purposes. In addition, a number of companies engaged in leasing operations have presented their financial statements upon a finance company concept rather than as a company engaged in the rental of equipment, the basis used for tax purposes.

Although the general effect of these different methods has been to improve the operating picture as compared with the results shown for tax purposes, they have been accepted as they more nearly match costs and revenues and hence the financial presentation is consistent with generally accepted accounting principles.

As a final thought, I would like to discuss briefly the procedure that has been adopted by many accounting firms in connection with new filings. It seems that, in a good many cases, the certifying accountants are not sure that the method of presentation, the type of disclosure or, in some cases,

the accounting principles followed will not be questioned by the staff, which may result in drastic revision and delay. In some of these cases, time and expense may be saved by reciting the facts in a letter to the Division and requesting a ruling, subject to review of the actual filing. In other cases that are more complicated a pre-filing conference may be arranged to discuss the filing. While the latter procedure has resulted in a time-consuming effort on the part of my office and should only be availed of in appropriate circumstances, in the long run it is my opinion that it has proved to be beneficial both to the public and to the Commission.